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SEC Rule 10b-16: Should the Federal Courts Allow Sophisticated Investors to Recover?

In 1968, Congress passed the Truth In Lending Act¹ (TILA) to ensure adequate disclosure of credit requirements to consumers by merchants and commercial lenders.² The TILA, however, specifically exempted securities dealers from compliance.³ Instead, Congress gave the Securities and Exchange Commission (SEC) the authority to adopt a credit disclosure rule analogous to the TILA in order to regulate the use of credit within the securities industry.⁴ In response to the congressional mandate, the SEC enacted rule 10b-16 in 1969.⁵ Rule

1. 15 U.S.C. §§ 1601-65 (1982).

2. See Note, *Securities Law—SEC Rule 10b-16—District of Columbia Circuit Limits Margin Call Disclosure By Broker-Dealers*—“*Liang v. Dean Witter & Co.*,” 51 N.Y.U. L. REV. 1050 (1976); H.R. REP. NO. 1040, 90th Cong., 1st Sess. (1967), reprinted in 1967 U.S. CODE CONG. & AD. NEWS 1962 [hereinafter cited as H.R. REP. NO. 1040].

3. See 15 U.S.C. § 1603(2) (1982). The statute states in part: “This title [15 U.S.C.S. § 1601 *et seq.*] does not apply to the following: transactions in securities or commodities accounts by a broker-dealer registered with the Securities and Exchange Commission.” *Id.* (brackets in original).

4. S. REP. NO. 392, 90th Cong., 1st Sess. 9 (1967) [hereinafter cited as SENATE REPORT 392]. The Senate report stated:

The Committee [Senate Committee on Banking & Currency] has been informed by the Securities and Exchange Commission that the Commission has adequate regulatory authority under the Securities Exchange Act of 1934 to require adequate disclosure of the costs of such credit. The Committee has also been informed in a letter from the SEC that “the Commission is prepared to adopt its own rules to whatever extent may be necessary.”

In recommending an exemption for stock-broker margin loans in the bill, the Committee intends for the SEC to require substantially similar disclosure by regulation as soon as it is possible to issue such regulation.

Id.

5. 17 C.F.R. § 240.10b-16 (1985). Rule 10b-16 provides in relevant part:

(a) It shall be unlawful for any broker or dealer to extend credit, directly or indirectly, to any customer in connection with any securities transaction unless such broker or dealer has established procedures to assure that each customer:

(1) Is given or sent at the time of opening the account, a written statement or statements disclosing (i) the conditions under which an interest charge will be imposed; (ii) the annual rate or rates of interest that can be imposed; (iii) the method of computing interest; (iv) if rates of interest are subject to change without prior notice, the specific conditions under which they can be charged; (v) the method of determining the debit balance or balances on which interest is to be charged and whether credit is to be given for credit balances in cash accounts; (vi) what other charges resulting from the extension of credit, if any, will be made and under what conditions; and (vii) the nature of any interest or lien retained by the broker or dealer in the security or other property held as collateral and the conditions under which additional collateral can be required.

17 C.F.R. § 240.10b-16 (1985).

10b-16 effectively regulates the disclosure of credit terms, especially in margin credit transactions.⁶

The primary focus of rule 10b-16 is proper disclosure of credit terms with respect to margin credit accounts.⁷ Failure of a securities firm to disclose credit requirements or properly establish effective disclosure procedures may result in an action by the SEC forcing compliance.⁸ Rule 10b-16, however, does not indicate whether a violation of the rule will permit a private cause of action.⁹ Additionally, the SEC Release¹⁰ that accompanied rule 10b-16 does not indicate whether private individuals may bring an action based upon a violation by a securities firm.¹¹

Historically, lower federal courts have allowed private individuals to maintain a cause of action against securities firms based upon violations of numerous securities related statutes.¹² These actions were allowed despite the absence of a specific reference to a private cause of action.¹³ The United States Supreme Court, however, has adopted a stricter test for implying private causes of action under SEC rules and regulations.¹⁴ As a result, the lower federal courts conflict on whether a private cause of action exists under rule 10b-16.¹⁵

This comment will address the issue of whether a private cause of action under rule 10b-16 can be maintained, and whether such an action would survive review by the Supreme Court in light of recent

6. Margin trading involves the purchase of securities or commodities on credit. In the typical transaction, the investor finances a portion of the purchase price of the securities. The broker then supplies the remaining funds in the form of a loan. The securities act as collateral for the loan. See Note, *SEC Rule 10b-16 and the Regulation of Margin Credit*, 87 YALE L.J. 372, 372 n.5 (1977); H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* § 296 n.12.

7. See Browning & Jackson, *Brokers Beware! Private Cause of Action May Exist Under Margin Account Disclosure Rules*, 13 SEC. REG. L.J. 3, 4 (Fall 1985).

8. For example, the SEC may refuse to declare the registration of securities effective. See 15 U.S.C. § 77h(b) (1982). The SEC may also conduct hearings to determine if violations have occurred or deny, suspend, or revoke the registration of broker-dealers. See 15 U.S.C. § 78o(b)(4) (1982). In addition, the SEC may turn over evidence of fraud or a willful violation of a regulation or rule to the Department of Justice recommending that criminal prosecution be initiated. See Schneider, *Implying Private Rights and Remedies Under the Federal Securities Acts*, 62 N.C.L. REV. 853, 859 n.32 (1984).

9. See *infra* notes 59-69 and accompanying text.

10. Securities Exchange Act Release No. 34-8773, 34 Fed. Reg. 19,717 (1969).

11. See *infra* notes 59-69 and accompanying text.

12. See *infra* notes 24-58 and accompanying text.

13. See *infra* notes 24-58 and accompanying text.

14. See *infra* notes 24-58 and accompanying text.

15. See, e.g., *Liang v. Dean Witter & Co., Inc.* 540 F.2d 1107, 1113 (D.C. Cir. 1976) (private cause of action under rule 10b-16 is assumed to be available); *Establisment Toomis v. Shearson Hayden Stone*, 459 F. Supp. 1355, 1361 (S.D.N.Y. 1978) (no private cause of action under rule 10b-16); *Robertson v. Dean Witter Reynolds, Inc.*, 749 F.2d 530, 540 (9th Cir. 1984) (private cause of action allowed under rule 10b-16).

Supreme Court and lower federal court decisions.¹⁶ The issue of whether scienter should be an element of a cause of action under rule 10b-16 will then be discussed.¹⁷ Finally, recent court decisions within the securities area will be examined to determine whether the courts should consider plaintiff's level of business sophistication before permitting a private cause of action under rule 10b-16.¹⁸ This comment will conclude that a private cause of action should be implied under rule 10b-16,¹⁹ and that, furthermore, rule 10b-16 will withstand Supreme Court review.²⁰ Considering the potential for abuse of the securities laws by investors who trade on margin, scienter should be required as an element of the implied cause of action.²¹ In conclusion, this comment will argue that courts should examine the level of sophistication of each particular plaintiff in deciding whether a cause of action does indeed exist.²² A means by which the courts may determine the level of sophistication necessary to deny recovery under rule 10b-16 will be proposed.²³ First, an examination of Supreme Court cases will illustrate the availability of implied causes of action under a number of securities laws.

IMPLIED PRIVATE CAUSES OF ACTION UNDER THE SECURITIES ACTS

In 1916, the Supreme Court in *Texas & Pacific Railway v. Rigsby*²⁴ first recognized the ability of a private party to state a cause of action under a federal statute that did not expressly provide a private remedy.²⁵ Within the securities area, the earliest lower court decisions allowed a private cause of action to be implied based upon a tort theory of recovery.²⁶ In 1964, the Supreme Court in *J. I. Case Co.*

16. See *infra* notes 24-128 and accompanying text.

17. See *infra* notes 129-49 and accompanying text.

18. See *infra* notes 150-219 and accompanying text.

19. See *infra* notes 113-28 and accompanying text.

20. See *infra* notes 113-28 and accompanying text.

21. See *infra* notes 129-49 and accompanying text.

22. See *infra* notes 150-219 and accompanying text.

23. See *infra* notes 220-28 and accompanying text.

24. 241 U.S. 33 (1916).

25. The Court stated that failure to abide by a statute "is a wrongful act, and where it results in damage to one of the class for whose especial benefit the statute was enacted, the right to recover the damages from the party in default is implied. . . ." *Id.* at 39. See Schneider, *supra* note 8, at 853 (discussion of *Rigsby*).

26. See Schneider, *supra* note 8, at 862. The courts reasoned that a party injured by a violation of a statute that was enacted to protect an interest of the party could recover based upon a statutorily imposed duty, notwithstanding the absence of an express private cause of action. *Id.* See, e.g., *Baird v. Franklin*, 141 F.2d 238, *cert. denied*, 323 U.S. 737 (1944) (implied private cause of action under § 6(b) of the Exchange Act, 15 U.S.C. § 78f(b) (1982)).

*v. Borak*²⁷ first upheld an implied private cause of action in the securities area.²⁸ The Court held that a corporate shareholder could sue for damages resulting from a violation of section 14(a) of the Securities Exchange Act of 1934 (1934 Act) regulating the circulation of proxy statements.²⁹ In determining whether a private cause of action could be implied under section 14(a), the Court examined the legislative history to determine whether Congress intended to recognize a private cause of action.³⁰ The Court determined protection of investors was a goal of section 14(a) and the statutory language implied the availability of judicial relief where necessary to achieve that result.³¹

In *Superintendent of Insurance v. Banker's Life and Casualty Co.*,³² the Supreme Court recognized an implied private cause of action under section 10(b) of the 1934 Act.³³ Unfortunately, the Court did not indicate how or when a private cause of action should be implied under the federal statute.³⁴ In a footnote, the Court simply stated that a private cause of action is implied under section 10(b).³⁵ The Court did not provide a framework for analyzing whether a cause of action could be implied from a federal statute until 1975, in *Cort v. Ash*.³⁶

27. 377 U.S. 426 (1964).

28. *Id.* at 433-34.

29. *Id.* See Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n(a) (1982). Section 14(a) does not expressly provide for a private cause of action but does stipulate certain activities as being unlawful. Section 14(a) provides as follows:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

15 U.S.C. § 78n(a) (1982).

30. *Borak*, 377 U.S. at 432.

31. *Id.* See *Schneider*, *supra* note 8, at 865. Justice Clark's majority opinion in *Borak* did not apply the tort theory used by the lower federal courts at the time. Rather, the implication of a private cause of action was based primarily on legislative intent. See *Schneider*, *supra* note 8, at 865.

32. 404 U.S. 6 (1971).

33. *Id.* at 13. Section 10(b) provides:

It shall be unlawful for any person.

.
(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1982).

34. *Superintendent of Insurance*, 404 U.S. at 13.

35. *Id.* at 13 n.9. See *Schneider*, *supra* note 8, at 870.

36. 422 U.S. 66 (1975).

In *Cort*, the Court promulgated a four-factor test for determining whether Congress intended to allow a private cause of action to be maintained.³⁷ The Court stated that in situations in which federal law clearly has granted certain rights to a particular class of citizens, express legislative intent to create a private cause of action need not be shown.³⁸ Although the Supreme Court appears willing to imply private causes of action under federal statutes when *Cort* is met, in 1977 the Court began to take a more restrictive view in this area.

In *Piper v. Chris-Craft Industries*,³⁹ the Supreme Court began to limit the implication of private causes of action under federal statutes which do not expressly provide a private remedy.⁴⁰ The Court refused to interpret the *Cort* test to require a determination whether Congress intended to allow private suits.⁴¹ Instead, the Court held the correct interpretation was to determine whether an implied private cause of action was necessary to achieve the goals determined by Congress when the statute in question was enacted.⁴² Hence, an implied private cause of action would be allowed only in circumstances in which the goals of Congress could not be met without implying a private cause of action.⁴³ Thus, the Court, in a holding limited to the particular facts in *Piper*, refused to allow a private cause of action to be implied under section 14(e) of the 1934 Act.⁴⁴

37. *Id.* at 78. The four factors promulgated by the Court in *Cort* are as follows: First, is the plaintiff one of the class for whose especial benefit the statute was enacted, that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the states, so that it would be inappropriate to infer a cause of action based solely on federal law?

Id. Interestingly, *Cort* did not involve a securities statute but § 610 of the 1948 Election Act, which prohibited corporations from making contributions in connection with presidential elections. *Id.* at 68. See Schneider, *supra* note 8, at 873-74.

38. *Cort*, 422 U.S. at 82. The Court further stated that an explicit purpose to deny a private cause of action would be controlling. *Id.* See Schneider, *supra* note 8, at 873-74.

39. 430 U.S. 1 (1975).

40. *Id.* at 24-46. See Block, *Securities Litigation*, 10 SEC. REG. L.J. 270, 271 (1982).

41. *Piper*, 430 U.S. at 26. See Schneider, *supra* note 8, at 880.

42. *Piper*, 430 U.S. at 26. See Schneider, *supra* note 8, at 880-81.

43. See Schneider, *supra* note 8, at 880-81.

44. *Piper*, 430 U.S. at 41. Section 14(e) of the Exchange Act, as added by § 3 of the Williams Act, 82 Stat. 457, provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation.

In 1979, the refusal of the Supreme Court to imply a private cause of action continued in *Touche Ross & Co. v. Redington*.⁴⁵ In *Touche Ross*, the Court refused to allow a private cause of action under section 17(a) of the 1934 Act.⁴⁶ In a footnote, the Court cautioned against an attempt to analogize the previously recognized implied private cause of action under section 10(b) in *Superintendent of Insurance* to an asserted right under section 17(a).⁴⁷ The Court in *Touche Ross* stated that, in recognizing an implied cause of action under section 10(b), the Court was merely acquiescing to twenty-five years of lower federal court decisions implying a private cause of action.⁴⁸ Section 17(a) did not have a similar history.⁴⁹ Therefore, the Court did not recognize an implied private cause of action.⁵⁰ The Court continued to narrow the availability of implied private causes of action under federal statutes in *Transamerica Mortgage Advisors, Inc. v. Lewis*.⁵¹

In *Transamerica*, the Court allowed the implication of a private cause of action under section 215 of the Investment Advisors Act of 1940.⁵² This act makes contracts in which formation or performance would violate the Act void as to the rights of the violator.⁵³

15 U.S.C. § 78n(e) (1982). The Court in *Piper* determined that the sole purpose of § 14(e) was to protect shareholders of target companies. See *Piper*, 430 U.S. at 35. Chris-Craft was both a tender offeror and shareholder in *Piper*. Thus, the Court reasoned that even if a private cause of action could be implied to shareholders of target companies, Chris-Craft could not be considered a proper shareholder by virtue of its status as a defeated tender offeror and, therefore, lacked standing. See *id.* at 42. See also *Schneider*, *supra* note 8, at 881 (discussion of the limited holding of *Piper*). In conclusion, the *Piper* Court did not specifically preclude the possibility of an implied private cause of action under § 14(3). The Court merely held that in this specific fact pattern such a remedy was not available. See *Piper*, 430 U.S. at 42. Specifically, the Court stated: "Our holding is a limited one. Whether shareholder-offerees, the class protected by § 14(e), have an implied private cause of action under § 14(e) is not before us, and we intimate no view on that matter. Nor is the target corporation's standing to sue an issue in this case." *Id.* at 42 n.28. For a detailed discussion of the *Piper* decision and the potential implications see *Schneider*, *supra* note 8, at 880-84.

45. 442 U.S. 560 (1979).

46. *Id.* at 567. The Court reemphasized that "the fact that a federal statute has been violated and some person harmed does not automatically give rise to a private cause of action in favor of that person." *Id.* at 568 (citing *Cannon v. University of Chicago*, 441 U.S. 677, 688 (1979)).

47. *Id.* at 577 n.19. In the text, the Court stated in reference to the decision in *Borak* allowing for an implied private cause of action under § 14(a) "[w]e do not now question the actual holding of that case, but we decline to read the opinion so broadly that virtually every provision of the Securities Acts gives rise to an implied private cause of action." *Id.* at 577.

48. *Id.* at 577 n.19 (citing *Cannon*, 441 U.S. at 690-93, n.13).

49. *Id.* at 577-78, n.19.

50. *Id.* at 578.

51. 444 U.S. 11 (1979).

52. *Id.* at 19.

53. Section 215 provides in part as follows:

(b) Every contract made in violation of any provision of this subchapter and every contract heretofore or hereafter made, the performance of which involves the viola-

The Court, however, refused to allow the implication of a private cause of action under section 206 of the Investment Advisors Act of 1940,⁵⁴ which prohibits fraudulent practice by investment advisors.⁵⁵ The language used in section 206 is very similar to that used in section 10(b) of the 1934 Act.⁵⁶ Thus, the Court has refused to allow a private cause of action under a statute very similar to a statute for which a private cause of action was implied eight years earlier.⁵⁷ This leads to the conclusion that implication of private causes of action under statutory provisions similar to section 10(b) and section 206 may not withstand Supreme Court review absent a long history of lower court decisions acquiescing in the implication of a private cause of action. In light of the stricter standard of review employed by the Supreme Court in allowing private causes of action under federal statutes, the lower federal courts have struggled since 1976 with the question whether a private cause of action may be implied under rule 10b-16.⁵⁸ Prior to a discussion of applicable case law, a discussion of the legislative history of rule 10b-16 will be presented.

tion of, or the continuance of any relationship or practice in violation of any provision of this subchapter, or any rule, regulation, or order thereunder, shall be void (1) as regards to rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision.

15 U.S.C. § 80b-15 (1982).

54. 15 U.S.C. § 80b-6 (1982). Section 206 provides as follows:

It shall be unlawful for any investment adviser by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud any client or prospective client, (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; (3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction; (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Id.

55. *Transamerica*, 444 U.S. at 25.

56. Compare 15 U.S.C. § 806-g (1982) (Rule 206) with 15 U.S.C. § 78j(b) (1982) (section 10(b)). See *supra* notes 33 (text of § 10(b)) and 54 (text of Rule 206).

57. See *supra* notes 32-35 and accompanying text.

58. See *supra* note 15 and accompanying text.

RULE 10b-16

A. *Legislative Intent*

The United States Supreme Court places emphasis upon legislative intent and purpose when interpreting statutory enactments.⁵⁹ Therefore, the determination of the legislative intent behind rule 10b-16 is critical in analyzing whether a private cause of action can be implied. Unfortunately, when Congress passed the TILA and authorized the SEC to promulgate a *similar* rule for the securities industry, no guidance was given regarding whether the rule should be *identical* to the TILA.⁶⁰ Since the TILA primarily concerns the protection of financially unsophisticated consumers,⁶¹ a question remains whether the SEC was expected to develop a rule to protect similar unsophisticated investors in the specialized and sophisticated field of trading on margin credit. In Senate hearings, the drafters of the TILA stated that margin traders were sophisticated investors who did not need statutory protection.⁶² The Subcommittee on Consumer Affairs of the House Committee on Banking and Currency decided to allow the SEC to promulgate a rule governing margin trading. The Committee, however, failed to discuss the type of investors that should be afforded protection under the rule.⁶³

SEC Release No. 34-8777,⁶⁴ which accompanied the inception of rule 10b-16, stressed that the function of rule 10b-16 was to require disclosure.⁶⁵ The release emphasized that the disclosure should facilitate

59. See *supra* notes 24-58 and accompanying text.

60. See SENATE REPORT 392, *supra* note 4. See also Note, *supra* note 6, at 375 (discussion of the lack of clear legislative intent with respect to rule 10b-16); *Consumer Credit Protection Act Hearings on H.R. 11601 Before the Subcomm. on Consumer Affairs of the House Comm. on Banking and Currency*, 90th Cong., 1st Sess. (1967) [hereinafter cited as *H.R. 11601 Hearings*] (congressional discussion of the TILA and the promulgation by the SEC of a similar rule).

61. See Note, *supra* note 6, at 375. The primary concern of the TILA for unsophisticated investors may be implied from the types of transactions that are not covered within the TILA. *Id.* The TILA does not apply to extensions of credit for business or commercial purposes in excess of \$25,000 or for transactions in commodities or securities. *Id.* at 374. See *H.R. 11601 Hearings*, *supra* note 60, at 677 (Senator Proxmire testifying that credit transactions in excess of \$25,000 involved parties having the financial sophistication to bargain for any requisite disclosure).

62. See *H.R. 11601 Hearings*, *supra* note 60, at 677; see also Note, *supra* note 6, at 375 (discussion of *H.R. 11601 Hearings*).

63. See *H.R. 11601 Hearings*, *supra* notes 60, at 677.

64. 34 Fed. Reg. 19,717 (1969).

65. See *id.* The Release states in relevant part:

The Rule requires an initial disclosure and periodic disclosures. The initial disclosure is designed to insure that the investor, before his account is opened, understands the terms and conditions under which credit charges will be made. This will enable him to compare the various credit terms available to him and to understand the methods used in computing the actual credit charges. The periodic statement will inform the

investor understanding of credit terms and accurate assessment of credit costs.⁶⁶ This language is very similar to that in the stated purpose of the TILA.⁶⁷ Unlike the TILA, however, rule 10b-16 does not provide expressly for a private cause of action.⁶⁸ Thus, in assessing whether a private cause of action should be implied under rule 10b-16, the legislative history surrounding both the TILA and rule 10b-16 provides little guidance in determining actual legislative intent as required in *Cort* and *Transamerica*.⁶⁹ Although the legislative intent surrounding rule 10b-16 is unclear, the lower federal courts nonetheless have attempted to fashion a cogent analysis of whether a private cause of action should be implied under rule 10b-16.

B. Federal Court Decisions

1. Liang and Establissment Toomis—*The Beginning of a Controversy*

In *Liang v. Dean Witter & Co., Inc.*,⁷⁰ the United States District Court for the District of Columbia was presented with the first occasion to discuss the possibility of implying a private cause of action under rule 10b-16.⁷¹ In *Liang*, the plaintiffs opened a margin account with Dean Witter & Co.⁷² At the time of opening, plaintiffs signed a Customers Agreement form and within a short time signed a Credit Charges form.⁷³ One year later, Dean Witter & Co. wrote to plaintiffs requesting an additional \$2,600 as collateral, since plaintiffs'

investor of the actual cost of credit and, with the aid of the initial disclosure, enable him to accurately assess that cost.

Id.

66. *Id.*

67. 15 U.S.C. § 1601 (1970). The preamble of the TILA originally read as follows:

The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit.

Id. See also Note, *supra* note 2, at 1059 (discussing how language in SEC Release No. 34-8773 is similar to the purpose of the TILA).

68. Compare 15 U.S.C. § 1640(a) (1982) (elements of the TILA providing for a private cause of action) with 17 C.F.R. § 240.10b-16 (1985) (elements of rule 10b-16 which do not provide for a private cause of action).

69. See *supra* notes 37-38 and accompanying text.

70. 540 F.2d 1107 (D.C. Cir. 1976).

71. *Id.* at 1109.

72. *Id.*

73. *Id.* The Customers Agreement provided in part as follows:

You are hereby authorized, in your discretion, should the undersigned die or should you for any reason whatsoever deem it necessary for your protection, to sell any

securities margin was not sufficient at the current price.⁷⁴ Plaintiffs did not meet the margin call⁷⁵ and the securities were sold.⁷⁶

Plaintiffs argued that the Customers Agreement and Credit Charges forms supplied by Dean Witter & Co. did not comply with rule 10b-16(a)(1)(vii).⁷⁷ The *Liang* court discussed the general history of rule 10b-16 and concluded that failure to properly disclose the possible requirement of additional collateral would constitute a violation of rule 10b-16.⁷⁸ The court addressed the crucial issue regarding an implied private cause of action in a footnote.⁷⁹ The *Liang* court "assumed" that since rule 10b-16 was somewhat similar to section 10(b) of the 1934 Act and rule 10b-5, a private cause of action should be implied under rule 10b-16.⁸⁰

Two years later, in 1978, the United States District Court for the District of New York in *Establissement Toomis v. Shearson Hayden*

or all of the securities and commodities or other property which may be in your possession or which you may be carrying for the undersigned. . . . Such sale . . . may be made according to your judgment and may be made, at your discretion . . . without advertising the same and without notice to the undersigned.

Id. The Credit Charges form read in pertinent part as follows:

5. LIENS AND COLLATERAL—As provided in our Customer's Agreement, we have a general lien upon all securities which we hold for you for the discharge of all your obligations to us, however arising and irrespective of the number of accounts you maintain. We may at any time require you to deposit cash or such additional collateral as, in our sole discretion, we determine is necessary as security for your obligation to us.

Id.

74. *Id.*

75. When the amount of an investor's collateral declines through a reduction in stock price, the broker-dealer will require the investor to supply additional funds. This process is typically referred to as a *margin call*. See Note, *supra* note 2, at 378 n.28.

76. *Liang*, 540 F.2d at 1109-10.

77. *Id.* at 1110. Rule 10b-16(a)(1)(vii) states in relevant part:

(a) It shall be unlawful for any broker or dealer to extend credit, directly or indirectly, to any customer in connection with any securities transaction unless such broker or dealer has established procedures to assure that each customer:

(1) is given or sent at the time of opening an account, a written statement or statements disclosing . . . (vii) the nature of any interest or lien retained by the broker or dealer in the security or other property held as collateral and the conditions under which additional collateral can be required. . . .

17 C.F.R. § 240.10b-16 (1985).

78. *Liang*, 540 F.2d at 1111-12.

79. *Id.* at 1113 n.25.

80. *Id.* Rule 10b-5, promulgated under § 10(b) provides as follows:

It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person, in the connection with the purchase

Stone, Inc.,⁸¹ rejected the possibility of an implied private cause of action under rule 10b-16.⁸² The basis for rejecting the plaintiff's argument for an implied cause of action was that the court was "unaware" of any case that specifically allowed such a claim.⁸³ Thus, the court assumed that a private cause of action under rule 10b-16 could not be implied.⁸⁴ Since the decision in *Establissement Toomis*, only one lower federal court has denied a private cause of action under rule 10b-16.⁸⁵

The majority of lower federal courts have recognized an implied private cause of action under rule 10b-16.⁸⁶ Although the majority of courts have implied a private cause of action under rule 10b-16, the courts have split regarding the proper method of analysis to allow the action.⁸⁷ Since the establishment of the correct method of analysis ultimately may affect whether the Supreme Court will allow a private cause of action to be implied under rule 10b-16, two competing methods will be discussed.

2. The Correct Method of Analysis—TILA Versus Section 10(b)

The lower federal courts have not been consistent in the method employed to determine if a private cause of action may be implied

or sale of any security.

17 C.F.R. § 240.10b-5 (1985).

81. 459 F. Supp. 1355 (S.D.N.Y. 1978).

82. *Id.* at 1361.

83. *Id.*

84. *See id.*

85. *See Furer v. Paine, Webber, Jackson & Curtis, Inc.*, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶98,701 (C.D. Cal. 1982). The *Furer* court stated with respect to allowing a private cause of action under Rule 10b-16 "[t]he creation of such a private remedy would open a potentially large new area for litigation. In the absence of a clear and unambiguous showing that Congress intended such a result, the Court declines to find a private right of action implied in the Rule." *Id.* The continued viability of the reasoning in *Furer* is in doubt, however, considering the *Robertson* decision in the Ninth Circuit Court of Appeals which held that a private cause of action may be implied under rule 10b-16. *See infra* notes 101-12 and accompanying text.

86. *See Angelastro v. Prudential Bache Securities, Inc.*, 764 F.2d 939, 950 (3rd Cir. 1985), *cert. denied*, 106 S. Ct. 267 (1985); *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1358 n.8 (11th Cir. 1985) (the court did not specifically address the issue of whether a private cause of action could be implied, but assumed *arguendo* that such a cause of action could exist); *Granville Market Letter v. Oppenheimer & Co., Inc.*, 610 F. Supp. 923, 923 (D. Fla. 1985); *Abeles v. Oppenheimer & Co., Inc.*, 597 F. Supp. 532, 536 (N.D. Ill. 1983); *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303, 1321 (E.D. Va. 1981); *Stephens v. Reynolds Securities, Inc.*, 413 F. Supp. 50, 52 (N.D. Ala. 1976) (court did not specifically state whether private cause of action under rule 10b-16 could be implied, but allowed recovery under the rule); *Torn v. Rosen*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶91,603, 99,070 (S.D.N.Y. Aug. 3, 1984); *Slomiak v. Bear Sterns & Co., Inc.*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶91, 590, 99,026 (S.D.N.Y. July 24, 1984).

87. *See infra* notes 88-112 and accompanying text.

under rule 10b-16.⁸⁸ The *Liang* court did not address directly *why* rule 10b-16 may give rise to a private cause of action. The court discussed both the TILA and rule 10b-5, the antifraud statute, concluded rule 10b-16 was similar to both.⁸⁹ The *Liang* court stated, however, that since a private cause of action is permitted under section 10(b) and rule 10b-5, a private cause of action "should" exist under rule 10b-16.⁹⁰ The court, however, failed to state any supporting rationale.⁹¹ Thus, the first federal court to address the issue of a private cause of action under rule 10b-16 failed to state a reason why a private cause of action could be implied.⁹²

The court in *Haynes v. Anderson & Strudwick*⁹³ was the first to specifically discuss whether a cause of action could be implied under rule 10b-16. The *Haynes* court reasoned that rule 10b-16 was promulgated as the analogue of the TILA in federal securities law.⁹⁴ Therefore, the court considered whether Congress created a private cause of action under the TILA to determine if a similar cause of action should exist under rule 10b-16.⁹⁵ Since the TILA reveals that Congress created an express cause of action for customers when lenders fail to comply with the TILA, the *Haynes* court concluded that a private cause of action did in fact exist under rule 10b-16.⁹⁶ Surprisingly, the method of analysis followed by the court in *Haynes* has found support in *Furer v. Paine Webber Jackson & Curtis, Inc.*,⁹⁷ which held that a private cause of action did not exist under rule 10b-16.⁹⁸ The *Furer* court reasoned that brokers were exempted from the TILA because Congress did not want a private cause of action

88. See, e.g., *Robertson*, 749 F.2d at 534-37 (private cause of action based on § 10(b) and rule 10b-5); *Haynes*, 508 F. Supp. at 1320-21 (private cause of action based on the TILA).

89. *Liang*, 540 F.2d at 1110-11.

90. *Id.* at 1113 n.25.

91. *Id.*

92. *Id.* Specifically, the *Liang* court stated "[i]t may safely be assumed that noncompliance with Rule 10b-16 provides the basis for a private cause of action." *Id.*

93. 508 F. Supp. 1303 (1981).

94. *Id.* at 1320.

95. *Id.* Prior to this determination, the *Haynes* court acknowledged that the *Cort* factors should be considered in deciding whether to imply a private cause of action. *Id.* at 1319. In addition, the *Haynes* court recognized the *Cort* factors were refined in *Transamerica* so that "what must ultimately be determined is whether Congress intended to create the private remedy asserted." *Id.* at 1319 (citing *Transamerica*, 444 U.S. at 15).

96. *Haynes*, 508 F. Supp. at 1320-21. The *Haynes* court further supported this conclusion by noting that rule 10b-16 was promulgated under § 10(b) of the 1934 Act and felt that the court would be inconsistent if a private cause of action were permitted under rule 10b-5 and not under rule 10b-16. *Id.* Although the court in *Haynes* does mention § 10(b), the major emphasis of the decision is on the TILA with the § 10(b) analysis only providing additional support for the decision. *Id.*

97. [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶98,701 (C.D. Cal. 1982).

98. *Id.* at 93,495.

under the TILA to apply to brokers.⁹⁹ The majority of courts, however, have based a finding of an implied private cause of action under rule 10b-16 on section 10(b) of the 1934 Act.¹⁰⁰

The recent decision by the Ninth Circuit Court of Appeals in *Robertson v. Dean Witter Reynolds, Inc.*¹⁰¹ details the analysis under section 10(b) employed by the majority of lower federal courts.¹⁰² The *Robertson* court reasoned that both Congress and the SEC recognized that the authority of the SEC to promulgate the margin trading regulation of credit came from section 10(b) of the 1934 Act, and not the TILA.¹⁰³ Thus, the court decided not to rely upon the legislative history of the TILA.¹⁰⁴ Rather, the court stated the underlying statute from which a private cause of action must be implied is section 10(b).¹⁰⁵ Since the existence of an implied private cause of action under section 10(b) was well established,¹⁰⁶ and the proper statute to apply was section 10(b), the *Robertson* court then determined that the implied private cause of action under section 10(b) may be implied into rule 10b-16.¹⁰⁷

The *Robertson* court recognized statutory interpretation should focus on legislative intent to find an implied private cause of action under a federal statute.¹⁰⁸ Moreover, the court recognized that a private cause

99. *Id.* The *Furer* court stated:

Thus, the *Haynes* court construed the exemption of brokers from the Truth in Lending Act as an expression of Congressional expectation that the SEC would promulgate regulations authorizing a private right to action. This is one possible construction, but it is not the only one. It is equally plausible that Congress exempted brokers from the Truth in Lending Act because it did not wish to extend the private right of action extended therein to apply to brokers.

Id.

100. See *supra* note 86 and accompanying text.

101. 749 F.2d 530 (9th Cir. 1984).

102. *Id.* at 535-37.

103. *Id.* at 535. This conclusion was based on the language in Senate Report 392 which states: "[t]he Committee has been informed by the Securities and Exchange Commission that the Commission has adequate regulatory authority under the Securities Exchange Act of 1934 to require adequate disclosure of the costs of such credit. . . ." *Id.* at 535 (citing S. REP. No. 392, 90th Cong., 1st Sess. 9 (1967)).

104. *Robertson*, 749 F.2d at 535.

105. *Id.*

106. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Superintendent of Ins. v. Bankers Life and Cas. Co.*, 404 U.S. 6, 13 n.9 (1971).

107. *Robertson*, 749 F.2d at 536. The court stated that since rule 10b-16 is "reasonably" related to § 10(b) "we find no justification for a departure from the general principle that the rulemaking power of an administrative agency is limited to implementation of statutory purposes." *Id.*

108. *Id.* See *supra* notes 24-58 and accompanying text. In examining statutory construction to find an implied cause of action under a statute, the implied remedy will also be read into the accompanying administrative rule. *Robertson*, 749 F.2d at 536 (citing *Hochfelder*, 425 U.S. at 213-14).

of action under section 10(b) was implied on the basis of long-standing judicial construction, rather than upon the basis of traditional congressional intent analysis.¹⁰⁹ Notwithstanding the lack of a long-standing judicial acquiescence to an implied private cause of action under rule 10b-16, the *Robertson* court held that rule 10b-16 was sufficiently "reasonably related" to section 10(b) and rule 10b-5 to allow a private cause of action to be implied.¹¹⁰ The decision of the *Robertson* court illustrates the view in the majority of lower federal courts that a private cause of action should be implied under rule 10b-16 through a section 10(b) analysis.¹¹¹ In light of the narrowing trend in recent Supreme Court cases involving implied private causes of action under the securities laws,¹¹² however, a strong possibility exists that the Supreme Court will not allow a private cause of action to be implied under rule 10b-16.

C. The Impact of Recent Supreme Court Decisions

Considering most courts have implied a private cause of action under rule 10b-16 through a section 10(b) analysis,¹¹³ the recent Supreme Court trend to limit implied private causes of action may jeopardize the continued viability of lower court decisions involving rule 10b-16.¹¹⁴ For example, the Supreme Court decision in *Transamerica* did not allow a private cause of action under section 206 of the Investment Advisors Act, a statute similar to section 10(b) and rule 10b-5.¹¹⁵ This

109. *Robertson*, 749 F.2d at 536.

110. *Id.* at 539. In support, the court cited from an amicus brief filed by the SEC at the request of the court in *Liang* which states in part:

We do not know whether Dean Witter's disclosure in this case, under all circumstances, was entirely appropriate. We believe however, that the plaintiff should be given an opportunity to establish whether the disclosure by Dean Witter in this case complied with the requirements of Rule 10b-16, and that Dean Witter should be given an opportunity to adduce such facts as may demonstrate that it either (a) did not violate Rule 10b-16; or (b) should not be assessed any damages, under the circumstances of this case.

Id. at 538 (citing *Liang*, 540 F.2d at 1112 n.22, amicus brief at 9-10). In addition, the *Robertson* court determined that although rule 10b-16 is, in effect, a rule of disclosure, the rule is nonetheless reasonably related to the anti-fraud purposes of § 10(b) and, therefore, should enjoy the availability of an implied private cause of action. *Id.* at 538.

111. See, e.g., *Angelastro*, 764 F.2d at 949; *Greenblatt*, 763 F.2d at 1358 n.8; *Ables*, 597 F. Supp. at 536; *Torn*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶91,603, at 99,070; *Slomiak*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶91,590, at 99,026.

112. See *supra* notes 39-58 and accompanying text.

113. See *supra* note 111 and accompanying text.

114. See *supra* notes 24-58 and accompanying text; see also Block, *supra* note 40, at 271.

115. *Transamerica*, 444 U.S. at 24-25. See *supra* notes 52-58 and accompanying text.

refusal supports the proposition that the Court may not allow an implied private cause of action under rule 10b-16.¹¹⁶

The most significant factor in the possible demise of an implied private cause of action under rule 10b-16 is the lack of any clear legislative intent.¹¹⁷ A *Cort* or *Transamerica* analysis, which many of the lower courts have applied to find implied private causes of action under other securities laws, may not survive Supreme Court review when applied to rule 10b-16.¹¹⁸ In addition, rule 10b-16 does not have the long history of lower federal court decisions favoring an implied private cause of action which was the most important factor in the eventual acquiescence by the Supreme Court of an implied private cause of action under section 10(b).¹¹⁹ In essence, the steadfast reliance of the lower federal courts on section 10(b) for implying a private cause of action under rule 10b-16 ultimately may prove fatal.¹²⁰

The four courts that specifically discussed the issue of an implied private cause of action under rule 10b-16, however, agreed that a private cause of action does exist.¹²¹ In addition, in the most recent Supreme Court section 10(b) case of *Herman & MacLean v. Huddleston*,¹²² the Court stated that the existence of an implied private

116. See *supra* notes 52-58 and accompanying text.

117. See *supra* notes 59-69 and accompanying text.

118. See *supra* notes 24-112 and accompanying text. The *Robertson* court, however, stated that since Rule 10b-16 was not enacted by Congress, but rather by the SEC acting on authority delegated by Congress, the proper two-step inquiry is: "(1) whether Congress delegated authority to establish rules implying a private right of action and (2) whether the rule in question was drafted such that this private right of action may legitimately be implied." *Robertson*, 749 F.2d at 534 (citing *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 679 (9th Cir. 1980)). The use of the *Jablon* test by the *Robertson* court was apparently in response to the clear lack of legislative intent behind Rule 10b-16 and the possible inapplicability of a *Cort* type test. *Robertson*, 749 F.2d at 534-35. However, all other federal courts have based an implied private cause of action under rule 10b-16 on an analysis of legislative intent through either the *Cort* test directly or through *Transamerica*. See *supra* note 86 and accompanying text. In *Transamerica*, the *Cort* test was narrowed to a focused inquiry on the question of congressional intent, either implicit or explicit, as evidenced by the language of the statute, contemporary context of the enactment of the statute, legislative history, and the place of the statute in the overall enforcement scheme. *Transamerica*, 444 U.S. at 23-24.

119. See *supra* note 48 and accompanying text. The Supreme Court acquiesced to over 25 years of lower federal court decisions in implying a § 10(b) private cause of action. See *Touche Ross*, 442 U.S. at 577 n.19 (explaining that the Supreme Court in *Transamerica* allowed a private cause of action under § 10(b) primarily because of the 25-year history of lower federal courts accepting the implication of such a cause of action). Rule 10b-16 has only a ten year history of acquiescence which may not be sufficient for the Supreme Court to agree to an implied private cause of action. See *supra* notes 70-71 and accompanying text.

120. See *supra* notes 52-58 and accompanying text.

121. See *Angelastro*, 764 F.2d at 950; *Robertson*, 749 F.2d at 536; *Greenblatt*, 763 F.2d at 1358 n.8 (assuming arguendo that a private cause of action may be implied); *Stephens*, 413 F. Supp. at 52.

122. 459 U.S. 375 (1983).

cause of action under section 10(b) is "simply beyond peradventure."¹²³ A strong argument exists that rule 10b-16 is essentially an extension of section 10(b).¹²⁴ Thus, although some very strong arguments may be presented in support of the eventual demise of the implication of a private cause of action under rule 10b-16, the concurrence among all circuit courts¹²⁵ and most district courts¹²⁶ that a private cause of action should be implied under rule 10b-16 indicates that a private cause of action under rule 10b-16 would survive a review by the Supreme Court.

Although the Supreme Court will most likely recognize an implied private cause of action under rule 10b-16 because of the similarity of the rule to section 10(b), the elements of a rule 10b-16 cause of action are not clear.¹²⁷ Many of the lower federal courts that have addressed the use of rule 10b-16 in a private action either have not mentioned the necessary elements of such an action or are in disagreement with respect to the necessary elements.¹²⁸ Specifically, the courts are unclear regarding whether scienter should be included as an element of a rule 10b-16 cause of action.

THE SCIENTER REQUIREMENT

In *Ernst & Ernst v. Hochfelder*,¹²⁹ the United States Supreme Court concluded that a plaintiff could not maintain a private cause of action for damages under section 10(b) or rule 10b-5 without alleging scienter.¹³⁰ The Court concluded that rule 10b-5 was adopted under the authority granted to the SEC under section 10(b).¹³¹ Therefore, the scope of rule 10b-5 cannot exceed the power granted to the SEC by Congress under section 10(b).¹³² The intent of Congress in drafting section 10(b) was to proscribe knowing or intentional misconduct.¹³³

123. *Id.* at 380; see also *supra* note 106 and accompanying text (existence of an implied private cause of action under § 10(b) is well established).

124. See *supra* notes 88-112 and accompanying text.

125. See *supra* note 121 and accompanying text.

126. See *supra* note 86 and accompanying text.

127. See Note, *supra* note 2, at 1066-76 (discussion of the elements of a rule 10b-16 private cause of action including scienter, reliance, materiality, and causation).

128. See, e.g., *Robertson*, 748 F.2d at 539-41 (in depth discussion of scienter resulting in the conclusion that scienter is a requirement); *Haynes*, 508 F. Supp. at 1321 (in depth discussion of scienter resulting in the conclusion that scienter is not a requirement); *Abeles*, 597 F. Supp. 532 (no discussion of scienter or any other element of a rule 10b-16 cause of action).

129. 425 U.S. 185 (1976).

130. *Id.* at 193. Scienter is defined as the "intent to deceive, manipulate, or defraud." *Id.* See generally W. PROSSER & W. KEETON, *THE LAW OF TORTS*, § 107 (5th ed. 1984).

131. *Hochfelder*, 425 U.S. at 199.

132. *Id.* at 214.

133. *Id.* at 197.

Thus, a suit under rule 10b-5 was considered defective if the plaintiff failed to prove scienter.¹³⁴

Liang was the first court to consider whether scienter should be a required element in an action based upon a violation of rule 10b-16.¹³⁵ The *Liang* court recognized that scienter was a necessary element for recovery under a rule 10b-5 action.¹³⁶ The court, however, failed to address the issue directly and remanded the case without a final decision about a rule 10b-16 requirement for scienter.¹³⁷

In *Haynes*, decided five years after *Liang*, the issue of whether to include the requirement of scienter in a rule 10b-16 action was addressed specifically.¹³⁸ The *Haynes* court stated that although scienter was a necessary element of a section 10(b) or rule 10b-5 cause of action, scienter was not an element of a private action implied under the TILA.¹³⁹ The *Haynes* court concluded that a requirement of scienter for a rule 10b-16 cause of action would be “foreign” to the plain language of rule 10b-16, since the rule is mechanical in nature and should be read consistently with the TILA.¹⁴⁰ While recognizing the decision was inconsistent with the requirements of a section 10(b) or rule 10b-5 claim, the *Haynes* court ruled that scienter nevertheless should not be an element of an implied cause of action under rule 10b-16.¹⁴¹

Conversely, in 1984, the court in *Robertson* found that scienter should be a required element of a rule 10b-16 implied private cause of action.¹⁴² The *Robertson* court ostensibly relied on the conclusion made by the Supreme Court in *Hochfelder* that the claimant must prove scienter in a section 10(b) or rule 10b-5 cause of action.¹⁴³ Since the court in *Robertson* concluded that an implied private cause of

134. *Id.* at 193. See Note, *supra* note 2, at 1067. The elements of reliance, materiality, and causation are not expressly rooted in the language of § 10(b). Nonetheless, courts have required proof of these elements in rule 10b-5 litigation. See Note, *supra* note 2, at 1069-70. A discussion of these elements, however, is beyond the scope of this comment.

135. *Liang*, 540 F.2d at 1113 n.25.

136. *Id.*

137. *Id.*

138. *Haynes*, 508 F. Supp. at 1321.

139. *Id.* Negligent noncompliance with the TILA is actionable. *Id.* Failure to comply with the Act does not have to be knowing or intentional. *Id.* at 1321 n.12. In addition, the TILA does provide that a bona fide unintentional error is a defense from civil liability. *Id.* See 15 U.S.C. § 1640 (1982).

140. *Haynes*, 508 F. Supp. at 1321.

141. *Id.* The conclusion reached by the *Haynes* court is not surprising considering the court had determined that the proper method of analyzing whether a private cause of action should be implied under rule 10b-16 was through the TILA. See *supra* notes 93-96 and accompanying text.

142. *Robertson*, 749 F.2d at 539-41.

143. *Id.* at 540. See *supra* notes 129-34 and accompanying text.

action could be maintained under rule 10b-16 through section 10(b), scienter should be a required element of a cause of action under rule 10b-16 as well.¹⁴⁴ Since the *Robertson* decision, only one other court has specifically discussed the possibility of a scienter requirement under rule 10b-16.¹⁴⁵ That court concluded, without discussion, that such a requirement did exist.¹⁴⁶

The possibility of a scienter requirement under rule 10b-16 has been specifically addressed by only three courts.¹⁴⁷ Since the great majority of lower federal courts have based an implied private cause of action under rule 10b-16 on the language of section 10(b) and rule 10b-5, a strong presumption exists that scienter will be required in the future.¹⁴⁸ Considering the strong legislative intent to limit section 10(b), and presumably rule 10b-16, another logical limitation should be a review of the level of sophistication of each particular rule 10b-16 plaintiff.¹⁴⁹

A VIEW TOWARD THE PLAINTIFF

Most causes of action under rule 10b-16 are precipitated by plaintiff's failure to meet a required margin call.¹⁵⁰ Once the margin call is not met, the broker-dealer sells the securities being held as collateral.¹⁵¹ This sale usually results in a considerable loss to the investor.¹⁵² The investor then alleges that proper disclosure was not made

144. *Robertson*, 749 F.2d at 540. The court rejected the lower standard of proof required under the TILA since the court felt that the TILA had absolutely no application to a rule 10b-16 analysis. *Id.*

145. See *Granville Market Letter*, 610 F. Supp. at 922.

146. See *id.* The court noted that failure of a plaintiff to plead and prove scienter resulted in a summary judgment against the plaintiff. *Id.*

147. See *supra* notes 135-46 and accompanying text (discussion of *Liang*, *Haynes*, and *Robertson*).

148. See *supra* notes 129-34 and accompanying text (discussion of scienter requirement under § 10(b) and rule 10b-5).

149. See *supra* notes 129-34 and accompanying text; see also Note, *supra* note 2, at 1067-70 (discussion of scienter requirement under rule 10b-16).

150. See, e.g., *Robertson*, 749 F.2d at 533 (failure to meet a margin call of \$7,100); *Slomiak*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶91,590, at 99,023 (failure to meet margin call of \$155,000). In addition, suits have been brought under rule 10b-16 for failure to provide any disclosure. See, e.g., *Haynes*, 508 F. Supp. at 1308. Courts have required that a plaintiff who brings an action under § 10(b) must be a purchaser or seller of securities. See *Blue Chip Stamps*, 421 U.S. at 731-32. Considering the language of rule 10b-16, a similar requirement must be met before a plaintiff can bring an action under rule 10b-16. See Note, *supra* note 6, at 388.

151. See Note, *supra* note 6, at 378 n.28.

152. See, e.g., *Robertson*, 749 F.2d at 533 (failure to meet margin call resulted in loss of \$149,000); *Slomaik*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶91,590, at 99,023 (failure to meet requisite margin call and subsequent liquidation of securities by broker-dealer resulted in a loss of \$256,285).

under rule 10b-16 and seeks to recover the loss.¹⁵³ Many courts have recognized potential for abuse and have stressed that the securities laws should not be a system of investors' insurance.¹⁵⁴ Justice Friendly in his dissenting opinion in *Pearlstein v. Scudder & German*¹⁵⁵ (*Pearlstein I*), in which the majority held that a private cause of action may be implied under section 7(c) of the 1934 Act,¹⁵⁶ stated that:

As a result of it [section 7(c)], speculators will be in a position to place all the risk of market fluctuations on their brokers . . . any deterrent effect of the threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who, under the majority's view, is placed in the enviable position of "heads-I-win, tails-you-lose."¹⁵⁷

The requirement that a plaintiff prove scienter under section 10(b), rule 10b-5, and arguably rule 10b-16, poses a significant obstacle to obtaining a recovery.¹⁵⁸ Notwithstanding the difficulty in proving scienter, the potential for abuse of the securities laws by investors has led many courts to limit the possibility of recovery even more by examining the specific plaintiff's level of sophistication.¹⁵⁹

153. Essentially, the failure to comply with Rule 10b-16 may allow a margin account customer a put on the transactions which are carried on within the margin account. See Browning, *supra* note 7, at 3. A put is defined as an option to sell. See J. FRANCIS, INVESTMENTS: ANALYSIS AND MANAGEMENT 405 (3rd ed. 1980).

154. See, e.g., *List v. Fashion Park, Inc.*, 340 F.2d 457, 463 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965); *Barnett v. Anaconda Co.*, 238 F. Supp. 766, 770 (S.D.N.Y. 1965); see also Note, *supra* note 6, at 390 n.65.

155. 429 F.2d 1136 (2nd Cir. 1970).

156. 15 U.S.C. § 78g(c) (1982).

157. *Pearlstein*, 429 F.2d at 1148 (Friendly, J., dissenting). Justice Friendly's dissenting opinion became the majority view when *Pearlstein* was decided by the Second Circuit for a second time. The court stated:

We note that in our prior opinion in this case, emphasis was placed on the fact that "the federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit." (citations omitted). However, the addition of section 7(f) to the Exchange Act in 1970, 15 U.S.C. § 78g(f), as well as the promulgation by the Federal Reserve Board of Regulation X, 12 C.F.R. § 224 (1975), have now made it unlawful to *obtain* credit in violation of the margin requirements. The effect of these developments is to cast doubt on the continued viability of the rationale of our prior holding.

Pearlstein v. Scudder & German, 527 F.2d 1141, 1145 n.3 (2nd Cir. 1975) (emphasis by the court).

158. Proof of scienter demands an inquiry into the defendant's state of mind. See Note, *supra* note 2, at 1068-69. Thus, in a Rule 10b-16 action, the plaintiff must prove that a broker who made inadequate disclosure under rule 10b-16 knew that the failure to make disclosure to the customer would mislead the customer as to the broker's policy with respect to margin accounts. See *id.* Although the determination of a plaintiff's state of mind is a formidable task, most courts have allowed the defendant's mental state to be inferred from the surrounding circumstances. *Id.* at 1068.

159. See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). In determining whether employees should be protected by means of full disclosure under registration requirements of the 1934 Act, the court looked to the particular plaintiffs to determine if they had knowledge and sophistication sufficient that disclosure was not required. *Id.* at 126.

Historically, the level of sophistication of plaintiff investors has been a component of several securities laws.¹⁶⁰ This willingness to examine the level of sophistication of the plaintiff by the courts has affected at least one decision within the rule 10b-16 area.

A. *The Zerman v. Ball Decision*

In *Zerman v. Ball*,¹⁶¹ plaintiff brought an action for damages against a broker-dealer based upon a violation of a number of securities laws, including rule 10b-16.¹⁶² The plaintiff, Zerman, purchased a \$100,000 Government National Mortgage Association (GNMA) certificate for \$104,000 on margin.¹⁶³ Plaintiff also purchased an additional \$10,000

160. For example, SEC rule 146 contained objective guidelines providing for a private offering exemption from registration to be applicable if the offer involves "(3) purchasers whom the issuer reasonably believes to be sophisticated and financially able to bear the risk of investment. . . ." 17 C.F.R. § 230.146 (1974). Rule 146 has since been replaced by Regulation D which consists of six rules including rule 506 which states in relevant part:

The issuer shall reasonably believe immediately prior to making any sale that each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

17 C.F.R. § 230.506(b)(2)(ii) (1985). Thus, if an investor is not deemed either accredited or knowledgeable, a corporation may not issue securities without formal registration with the SEC. The term accredited investor is defined in part as:

(d) any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of that issuer;

(e) any person who purchases at least \$150,000 of the securities being offered, where the purchaser's total purchase price does not exceed 20 percent of the purchaser's net worth at the time of sale, or joint net worth with the person's spouse, for one or any combination of the following: (1) cash, (2) securities for which market quotations are readily available, (3) an unconditional obligation to pay cash or securities for which market quotations are readily available which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (4) the cancellation of any indebtedness owed by the issuer to the purchaser;

(f) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds \$1,000,000;

(g) Any natural person who had an individual income in excess of \$200,000 in each of the two most recent years and who reasonably expects an income in excess of \$200,000 in the current year. . . .

17 C.F.R. § 230.215 (1985). Although the term "sophisticated" has been removed since the adoption of Rule 506, the implication, nonetheless, is that protection in the form of formal registration requirements with the SEC will be afforded to only those investors who are not well versed in financial matters. See generally 15 U.S.C. § 77d(2) (1982) (private offering exemption).

161. 735 F.2d 15 (1984).

162. The plaintiff contended that the defendants violated the following: §§ 7, 10, 15, 20, and 29 of the Securities Exchange Act of 1934 (15 U.S.C. §§ 78g, 78j, 78o, 78t, 78cc (1982)), and Rules 10b-5, 10b-16 (17 C.F.R. §§ 240.10b-5, 240.10b-16 (1983)); §§ 12(2) and 17 of the Securities Act of 1933 (15 U.S.C. §§ 771(s), 77q (1982)); New York Stock Exchange Rules 401 and 405; National Association of Securities Dealers Rules of Fair Practice, Article III, § 2; and various provisions of Florida law. *Id.* at 17.

163. *Id.* at 18.

worth of bonds in cash.¹⁶⁴ The plaintiff sold the bonds for \$8,300 and sold the GNMA certificate for \$79,208.05.¹⁶⁵ In the complaint, plaintiff alleged the defendants knowingly made various false representations and omissions that were relied upon by plaintiff in making the investment decisions.¹⁶⁶ Plaintiff stated in the complaint “[d]efendants failed to apprise Zerman of the nature of a margin account and of the prospect that she might be called upon to provide more funds if the market fell. . . .”¹⁶⁷ Without deciding whether the plaintiff could recover under rule 10b-16 based upon an implied private cause of action, the *Zerman* court summarily dismissed the claim.¹⁶⁸ The court held that plaintiff failed to state a claim upon which relief could be granted.¹⁶⁹ The court concluded that no violation of any securities law exists for failure to disclose information known to anyone with even a cursory knowledge of the securities industry.¹⁷⁰ Specifically, the *Zerman* court reasoned that failure of a broker to disclose that additional collateral may be required if the value of the securities drops¹⁷¹ was information known to anyone involved with securities transactions and, thus, plaintiff simply failed to state a claim.¹⁷²

In addition, the *Zerman* court looked to the plaintiffs’ background in support of the decision.¹⁷³ The court had difficulty believing plaintiffs were unfamiliar with how margin accounts operate since a few

164. *Id.*

165. *Id.*

166. *Id.*

167. *Id.* This case does not follow the typical rule 10b-16 scenario since the plaintiff did not fail to meet a margin call and the plaintiff also signed a margin agreement. *Id.* at 21.

168. *Id.* at 21. The claim was properly dismissed pursuant to rule 12(b)(6) of the Federal Rules of Civil Procedure. *Id.*

169. *Id.*

170. *Id.* at 21. See *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir. 1980) (“It is not a violation of any securities law to fail to disclose a result that is obvious even to a person with only an elementary understanding of the stock market.”); *Alabama Farm Bureau Mutual Casualty Co. v. American Fidelity Life Insurance Co.*, 606 F.2d 602, 611 (5th Cir. 1979) (“The allegation would not . . . state a claim for which relief might be granted if it contended only that the defendants’ failed to reveal the obvious or well known.”). The *Zerman* court placed a great deal of emphasis upon the *Vaughn* and *American Fidelity* decisions in concluding that the plaintiff should not recover. See *Zerman*, 735 F.2d at 21. Unfortunately, neither of the two decisions involved a rule 10b-16 action. *Vaughn* involved a tender offer and *American Fidelity* involved a stock repurchase agreement. See *Vaughn*, 628 F.2d at 1216-18; *American Fidelity*, 606 F.2d at 605-06.

171. This would be a potential violation under rule 10b-16 which states in relevant part: “and (vii) the nature of any interest or lien retained by the broker or dealer in the security or other property held as collateral and the conditions under which additional collateral can be required.” 17 C.F.R. § 240.10b-16(a)(1)(vii) (1985).

172. *Zerman*, 735 F.2d at 21. Thus, the case indicates that notwithstanding the detailed list of disclosure required under rule 10b-16, some information may be so basic that any customer will be presumed to know it. See *Browning*, *supra* note 7, at 9.

173. *Zerman*, 735 F.2d at 21.

days before plaintiff made her purchases, plaintiff's husband filed suit against another brokerage firm over the liquidation of his margin account for failure to meet a margin call.¹⁷⁴ No other court has expressly followed the *Zerman* rationale of considering the background and sophistication of the specific plaintiff with regard to a rule 10b-16 cause of action.¹⁷⁵ This type of analysis, however, is common within the securities laws, especially in cases involving broker churning.

B. Churning

Churning occurs when a broker, acting in his or her own interests, engages in excessive trading of an account to generate commissions without regard to the investment objectives of the customer.¹⁷⁶ Considering the anti-fraud goals of section 10(b), the federal courts have recognized that churning results in a private cause of action under section 10(b) and rule 10b-5.¹⁷⁷ In order to prove that an account has been churned, the plaintiff must demonstrate three elements, including whether the broker exercised control over the account.¹⁷⁸ To determine whether a broker exercised the requisite control over a plaintiff's account, the lower federal courts have considered a number of factors, including the level of sophistication of the individual plaintiff.¹⁷⁹ As the level of sophistication increases, measured by factors

174. *Id.*

175. See, e.g., *Robertson*, 749 F.2d 530; *Angelastro*, 764 F.2d 939.

176. See Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869, 869 (1967). The SEC has provided a definition of churning which follows:

The term "manipulative, deceptive, or other fraudulent device or contrivance," as used in section 15(c) of the act, is hereby defined to include any act of any broker or dealer designed to effect with or for any customer's account in respect to which such broker or dealer or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

17 C.F.R. § 240.15c 1-7(a) (1985).

177. See, e.g., *Costello v. Oppenheimer & Co., Inc.*, 711 F.2d 1361, 1368 (7th Cir. 1983); *Thompson v. Smith Barney, Harris Upham & Co., Inc.*, 709 F.2d 1413, 1416-17 (11th Cir. 1983); *Miley v. Oppenheimer*, 637 F.2d 318, 324 (5th Cir. 1981); *Follansbee v. Davis, Skaggs & Co., Inc.*, 681 F.2d 673, 676 (9th Cir. 1982); *Landry v. Hemphill, Noyes & Co.*, 473 F.2d 365, 368 n.1 (1st Cir.), *cert. denied*, 414 U.S. 1002 (1973); *Hecht v. Harris Upham & Co.*, 430 F.2d 1202, 1206-07 (9th Cir. 1970).

178. The plaintiff must prove that (1) the trading in plaintiff's account was excessive in light of his investment objectives, (2) the broker in question exercised control over the trading in the account, and (3) the broker acted with intent to defraud or with willful reckless disregard for the investor's interests. See *Miley*, 637 F.2d at 324; *Mihara v. Dean Witter & Co., Inc.*, 619 F.2d 814, 821 (9th Cir. 1980); *Rolf v. Blyth, Eastman, Dillon & Co., Inc.*, 424 F. Supp. 1021, 1039-40 (S.D.N.Y. 1977), *aff'd in part and rev'd in part*, 570 F.2d 38, *cert. denied*, 439 U.S. 1039 (1978). See generally Note, *supra* note 176, at 871-79 (discussion of the elements of a churning cause of action).

179. See, e.g., *Miley*, 637 F.2d at 325; *Zurad v. Lehman Bros. Kuhn Loeb, Inc.*, 757 F.2d

including length of time plaintiff has dealt with investments, whether all advice from a broker was followed faithfully, and the profession of the plaintiff, the ability to recovery declines.¹⁸⁰

For example, in *Follansbee v. Davis, Skaggs & Co., Inc.*,¹⁸¹ plaintiff argued that the broker-dealer churned the plaintiff's account by making excessive trades in order to enhance the broker's commissions.¹⁸² In denying the plaintiff recovery, the *Follansbee* court focused upon three elements.¹⁸³ First, the court determined plaintiff was an investor who wanted to realize quick profits resulting from short term swings of the stock market.¹⁸⁴ The excessive trading element of a churning case is not established unless the frequency of the trades was unrelated to the customer's objectives.¹⁸⁵ Plaintiff's desire to make a quick profit refuted this allegation.¹⁸⁶

Secondly, the court determined that plaintiff clearly prohibited the defendant from controlling the account.¹⁸⁷ The court stated the proper question to be addressed in determining control was whether the customer had sufficient intelligence and understanding to evaluate the recommendations of the broker independently.¹⁸⁸ Third, the court found the background of the plaintiff supported the conclusion that

129, 131 (7th Cir. 1985); *Weiser v. Shwartz*, 286 F. Supp. 389, 390-91 (E.D. La. 1968); *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10th Cir. 1983) (use of level of sophistication to determine whether plaintiff justifiably relied on defendant's assertions in a rule 10b-5 action). If the plaintiff client is found to be naive or unsophisticated, the client is more likely to follow the dealer's recommendations and thus control may be indirectly demonstrated. See Note, *supra* note 176, at 872. Courts have not been consistent, however, in determining what is naive or unsophisticated. See Note, *supra* note 176, at 872-73. In addition, the analysis in *Mihara* leading to the determination whether control has been achieved has since been limited by the court in *Follansbee*. See *Follansbee*, 681 F.2d at 677. Specifically, the Ninth Circuit has cautioned against construing *Mihara* "to mean that the most sophisticated investor is not in control of his account simply because he follows the recommendations of his broker." *Id.* See *Tiernan v. Blyth, Eastman, Dillon & Co.*, 719 F.2d 1, 3 n.2 (9th Cir. 1983).

180. See, e.g., *Zurad*, 757 F.2d at 131 (plaintiff had previous experience within the stock market and entered into transactions contrary to the advice of the broker, yet recovery allowed); *Follansbee*, 681 F.2d at 677 (plaintiff had college degree in economics and taken a course in accounting, yet recovery denied); *Yopp v. Siegal Trading Co., Inc.*, 770 F.2d 1461, 1466 (9th Cir. 1985) (plaintiff was an experienced, college educated businessman and president of a multimillion dollar corporation, recovery denied).

181. 681 F.2d 673 (9th Cir. 1982).

182. *Id.* at 674-75.

183. *Id.* at 676-78.

184. *Id.* at 676.

185. *Id.*

186. *Id.* Since the plaintiff in *Follansbee* wanted to take advantage of short term swings in the market, heavy trading would be a normal course of action employed by the broker to accomplish this investment goal. Thus, the plaintiff could not properly allege that the broker churned the account. *Id.*

187. *Id.*

188. *Id.* at 677. Simply stated, a "customer retains control of his account if he has sufficient financial acumen to determine his own best interests and acquiesces in the broker's manage-

defendant did not control the account.¹⁸⁹ The court held that plaintiff had the requisite level of sophistication in financial matters to deny recovery.¹⁹⁰ The requisite level of sophistication to deny recovery, however, turns on the particular facts in a given case and that level often will not be shown in cases in which the fact situations appear similar.¹⁹¹

A cause of action based on churning is vastly different from an action based on disclosure violations under rule 10b-16.¹⁹² Both causes of action, however, emanate from an implied cause of action under section 10(b).¹⁹³ Since the *Robertson* court found rule 10b-16 sufficiently similar to the anti-fraud provision of section 10(b), courts should look to the level of sophistication of the plaintiff in a rule 10b-16 cause of action. In further support of this proposition, courts have been willing to look to the level of sophistication of a particular plaintiff in other areas of the securities law similar to rule 10b-16, including Regulation T and section 7 of the 1934 Act.

C. Regulation T and Section 7

Congress passed section 7 of the 1934 Act¹⁹⁴ in order to prevent

ment. . . ." *Id.* (citing *Carras v. Burns*, 516 F.2d 251, 258-59 (1975)). See *Newberger, Loeb & Co. v. Gross*, 563 F.2d 1057, 1070 (2nd Cir. 1977), *cert. denied*, 434 U.S. 1035, (1978) ("if a customer is fully able to evaluate his broker's advice and agree with the broker's suggestions, the customer retains control of the account."); *Tiernan*, 719 F.2d at 3 ("Consideration of the investor's sophistication in securities transactions and independent evaluation about the handling of his account are at least equally as important.").

189. *Follansbee*, 681 F.2d at 677.

190. *Id.* The court took into account plaintiff's degree in economics, enrollment in a course in accounting, ability to read financial reports, and the fact that plaintiff was a regular reader of investment advisory literature. *Id.*

191. See, e.g., *Zurad*, 751 F.2d at 131-33 (although plaintiff had some prior stock market experience before opening account at defendant's firm, had a moderate understanding of the market, and had entered into transactions on her own volition and contrary to the advice of the broker, the court decided these factors were not sufficient to deny recovery); *Hecht*, 283 F. Supp. 417, 433 ("although [plaintiff's] experience and competence were such that she knew her account was being actively traded in both securities and commodities, contrary to her claimed instructions and her claimed needs and objectives, her comprehension of market operations and business affairs beyond that were so meagre that she still had to rely upon [the defendant] concerning whether it was excessive under the circumstances.").

192. Compare *supra* notes 150-53 and accompanying text with *supra* notes 176-86 and accompanying text.

193. Compare *Robertson*, 749 F.2d at 536 (the private cause of action under § 10(b) may be implied into rule 10b-16) with *Follansbee*, 681 F.2d at 676 (churning is a violation of § 10(b) and rule 10b-5).

194. 15 U.S.C. § 78g (1982). Section 7 provides in pertinent part:

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules

excessive use of credit for the purchase of securities.¹⁹⁵ Subsection (a) authorized the Board of Governors of the Federal Reserve System to delineate rules and regulations regarding the amount of credit that may be extended initially and subsequently maintained on any security not considered an exempted security.¹⁹⁶ In addition, the Federal Reserve Board promulgated Regulation T¹⁹⁷ to control the amount of credit that may be extended by brokers and dealers.¹⁹⁸ Neither section 7 nor Regulation T expressly provide for a private cause of action.¹⁹⁹

The history of implying a private cause of action under section 7 or Regulation T parallels the history of most implied private causes of action under the securities acts.²⁰⁰ Most early court decisions, including *Pearlstein I*, implied a private cause of action under section 7.²⁰¹ Recent decisions, however, including *Pearlstein v. Scudder &*

and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, exempt in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe. . . .

(d) It shall be unlawful for any person not subject to subsection (c) to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in the contravention of such rules and regulations as the Federal Reserve Board [Board of Governors of the Federal Reserve System] shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. . . .

Id.

195. See 15 U.S.C. § 78g(a) (1982); see also Kanouse, *The Rise and Fall of the Private Cause of Action for Violation of Margin Requirements*, 98 BANKING L.J. 133, 134 (1981).

196. 15 U.S.C. § 78g(a) (1982); see Kanouse, *supra* note 195, at 134.

197. 12 C.F.R. §§ 220.1-220.130 (1985). In essence:

Regulation T governs the extension of credit by brokers. A purchase transaction carried out for a customer's special cash account complies with Regulation T if there is sufficient cash in the account at the time of the transaction, or the broker makes the purchase relying in good faith on the customer's agreement promptly to pay in full and his representation that he intends not to sell the security prior to payment. In addition, if payment is not made within seven business days after the purchase, the broker must "cancel or otherwise liquidate the transaction."

Comment, *Civil Liability for Margin Violations—The Effect of Section 7(f) and Regulation X*, 43 FORDHAM L. REV. 93, 94 (1974).

198. 12 C.F.R. §§ 220.1-220.130 (1985).

199. See Kanouse, *supra* note 195, at 135.

200. See generally *supra* notes 24-58 and accompanying text (discussion of implied private causes of action under the federal statutes).

201. See, e.g., *Pearlstein*, 429 F.2d at 1140 (private cause of action under § 7 allowed because private actions by market investors would be a "highly effective means of protecting the economy as a whole from margin violations by brokers and dealers."); *Serzysko v. Chase Manhattan Bank*, 290 F. Supp. 74, 78 (S.D.N.Y. 1968), *aff'd*, 409 F.2d 1360 (2d Cir. 1969), *cert. denied*, 396 U.S. 904 (1969) (implied private cause of action under § 7); *Remar v. Clayton Securities Corp.*, 81 F. Supp. 1014, 1017 (1949) (implied private cause of action under § 7). See also Kanouse, *supra* note 195, at 135-37.

*German*²⁰² (*Pearlstein II*), have tended to deny a private cause of action under section 7.²⁰³

As with the churning cases, federal courts analyze the level of sophistication of the plaintiff in an action brought under section 7 or Regulation T.²⁰⁴ Justice Friendly in his dissent in *Pearlstein I* spoke of the "innocent lamb."²⁰⁵ The justice stated "it may be proper in some instances to impose civil liability in furtherance of the subsidiary purpose of section 7(c), protection of the 'innocent lamb' attracted to speculation by the possibility of large profits with low capital investment."²⁰⁶ Justice Friendly found that the plaintiff in *Pearlstein I* could not have been considered unsophisticated given his experience as a speculator within the stock market.²⁰⁷

An example of federal court analysis of an implied private cause of action under Regulation T may be found in *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*²⁰⁸ In *Stern*, the court first determined that under the proper constitutional analysis set forth in *Cort*, a private cause of action could not be implied under Regulation T.²⁰⁹ The court further reasoned that even if a private cause of action did exist, this particular plaintiff failed to state a claim upon which relief could be

202. 527 F.2d 1141 (2nd Cir. 1975).

203. See *id.* at 1145. The *Pearlstein II* court stated:

However, the addition of section 7(f) to the Exchange Act of 1970, 15 U.S.C. § 7g(f), as well as the promulgation by the Federal Reserve Board of Regulation X, 12 C.F.R. § 224 (1975), have now made it unlawful to obtain credit in violation of the margin requirements. The effect of these developments is to cast doubt on the continued viability of the rationale of our previous holding.

Id. at 1145 n.3. Although *Pearlstein II* involved the question of damages under section 7 and not whether a private cause of action could be implied, the decision nonetheless had a significant impact on courts that previously had relied on *Pearlstein I*. See, e.g., *Utah State Univ. of Agric. & Applied Sci. v. Bear, Stearns & Co.*, 549 F.2d 164, 170 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977) (private cause of action should not be implied under Regulation T since "Congress imposed the margin requirements to protect the general economy, not to give the customer a free ride at the expense of the broker."); *Palmer v. Thompson & McKinnon Auchincloss, Inc.*, 427 F. Supp. 915, 921 (D. Conn. 1977) (section 7 meets *Cort* test and should be afforded a private cause of action). With the introduction of section 7(f) to the 1970 Exchange Act and the decisions in *Cort* and *Transamerica*, the continued viability of a private cause of action under either section 7 or Regulation T is in doubt. See Kanouse, *supra* note 195, at 141-46.

204. See, e.g., *Altschul v. Paine, Webber, Jackson & Curtis, Inc.*, 518 F. Supp. 591, 594 (S.D.N.Y. 1981) (denial of recovery under Regulation T because plaintiff was an experienced investor with over forty years experience in trading securities).

205. *Pearlstein*, 429 F.2d at 1148 (Friendly, J., dissenting).

206. *Id.*

207. *Id.*

208. 603 F.2d 1073 (4th Cir. 1979).

209. *Id.* at 1089. In light of *Cort*, the court decided that *Pearlstein I* was no longer binding authority and, therefore, the implication of a private cause of action under Regulation T could properly be denied. *Id.*

granted.²¹⁰ The decision was based upon the plaintiff's level of business sophistication.²¹¹

The *Stern* court considered a number of factors in concluding that plaintiff was too sophisticated to be allowed recovery under Regulation T.²¹² The plaintiff in *Stern* was a physician with a salary in excess of \$100,000 per year who practiced through a solely owned professional association.²¹³ In addition, the plaintiff had extensive experience in trading securities.²¹⁴ The plaintiff did not rely on the broker for advice in market operations.²¹⁵ Thus, based upon the plaintiff's level of business sophistication and the fact that the plaintiff was not a "small, inexperienced" investor, the *Stern* court determined the plaintiff failed to qualify as a proper plaintiff.²¹⁶

210. *Id.* at 1097.

211. *Id.* at 1093-97. The Court stated that a plaintiff must be a "small, inexperienced" investor to qualify as a plaintiff under § 7. *Id.* at 1093. See Comment, *Securities Exchange Act of 1934—Civil Remedies Based Upon Illegal Extension of Credit in Violation of Regulation T*, 61 MICH. L. REV. 940, 954 (1963) ("recovery [in private causes of action under § 7] should be denied to the sophisticated trader on the ground that he [was] an accomplice in the violation" and because "[d]enying him a remedy would serve as a greater deterrent to future violations . . . than allowance of relief."). The House Committee's report on § 7 states as follows:

The main purpose of these margin provisions in section 6 is not to increase the safety of security loans for lenders. Banks and brokers normally require sufficient collateral to make themselves safe without the help of law. Nor is the main purpose even protection of the small speculator by making it impossible for him to spread himself too thinly—although such a result will be achieved as a by-product of the main purpose.

The main purpose is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of other more desirable uses of commerce and industry—to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained by far higher rates into security loans and the New York call market.

H.R. REP. NO. 1383, 73rd Cong., 2d Sess. 7-9 (1934). See *Remar v. Clayton Security Corp.*, 81 F. Supp. 1014, 1017 (1949) (additional summary and application of House Report 1383). The *Remar* court concluded that although small speculator's protection was only a by-product of the main purpose of § 7, that by-product was sufficient to allow an implied private cause of action. *Id.* 1017.

212. *Stern*, 603 F.2d at 1093.

213. *Id.*

214. *Id.* at 1094. The court found of extreme importance the fact that plaintiff's trades included long and short positions. In addition, the plaintiff had been trading in stock puts and calls on the option market for a number of years. *Id.* For an in depth discussion of puts, calls, long and short positions see J. FRANCIS, *supra* note 153, at 401-12.

215. *Stern*, 603 F.2d at 1095.

216. *Id.* at 1097. As in *Zerman*, the *Stern* court refused to allow recovery to the plaintiff as a matter of law. Compare *Stern*, 603 F.2d at 1097 (summary judgment in favor of broker/defendant) with *Zerman*, 735 F.2d at 21 (complaint properly dismissed pursuant to rule 12(b)(6)). The *Stern* court recognized that whether a particular plaintiff can qualify as a small, inexperienced investor or should be regarded as a knowledgeable speculator is normally a factual question which should not be resolved on motion for summary judgment. See *Stern*, 603

An analysis of federal case law demonstrates a willingness by federal courts to look to the level of plaintiff sophistication before allowing recovery under various private causes of action implied from securities regulations.²¹⁷ Therefore, in the context of an implied private cause of action under rule 10b-16, courts should consider plaintiff's level of sophistication. In addition, since most lower federal courts have found an implied private cause of action under rule 10b-16 based on section 10(b),²¹⁸ and a churning cause of action falls within the ambit of the anti-fraud provisions of section 10(b),²¹⁹ to consider the level of sophistication in one action and not another would be an inconsistent application of the law. Since the courts have not set forth clear guidelines for determining the level of sophistication in securities actions which would prevent recovery, a framework for making this determination within the area of rule 10b-16 causes of action would prove helpful.

A PROPOSAL FOR THE DETERMINATION OF A PLAINTIFF'S LEVEL OF SOPHISTICATION

Plaintiff's level of sophistication should be one of a number of considerations in determining if recovery should be allowed in a rule 10b-16 action.²²⁰ Unless evidence of plaintiff's level of sophistication is overwhelming, as was the case in *Stern* and *Zerman*, the court should consider this evidence as a factor in the decision to grant or deny relief regardless of whether plaintiff has complied with rule 10b-16.²²¹ The following criteria should be weighed in determining the level of sophistication of a particular plaintiff: (1) amount of investment ex-

F.2d at 1097. In *Stern*, however, the record was clear that the plaintiff was a knowledgeable investor and the district court properly granted summary judgment. *Id.* The *Stern* decision is not the only decision to hold that the question of sophistication may be addressed on motion for summary judgment. See, e.g., *Altschul*, 518 F. Supp. at 594 (defendant's motion for summary judgment granted as to the churning violation may be upheld since the defendants have shown that the plaintiff was a "sophisticated investor who had full knowledge of the speculative nature of his investments and who failed to object to the course of investment until the gamble failed.").

217. This willingness stems from the fear that plaintiffs may potentially abuse Securities Acts for their own aggrandizement. See *supra* notes 129-49 and accompanying text. Specifically, the courts have become increasingly aware of the potential "heads-I-win, tails-you-lose" syndrome. See *supra* notes 150-60 and accompanying text.

218. See *supra* note 102 and accompanying text.

219. See *supra* note 177 and accompanying text.

220. Other factors to consider include whether the broker-dealer has established procedures to comply with Rule 10b-16 and whether the plaintiff has signed a customer's agreement. See generally 17 C.F.R. § 240.10b-16 (1985).

221. See *supra* notes 150-219 and accompanying text.

perience;²²² (2) profession;²²³ (3) education;²²⁴ (4) specific knowledge of margin trading;²²⁵ (5) the use of more than one brokerage firm to trade on margin;²²⁶ (6) amount of control exercised by the securities firm in making margin decisions;²²⁷ and (7) whether the plaintiff initiated the margin trading.²²⁸ Many of these criteria have been used by federal courts in determining levels of sophistication in related securities statutes. This comment suggests that they may also be applied to rule 10b-16 causes of action.

No conclusive standard should be adopted to find the requisite level of sophistication to deny recovery. This comment suggests that the above factors should be balanced in making the final decision. The presence of a number of these factors, especially a great degree of investment experience coupled with previous knowledge of margin trading, will lead to the inference of sophistication and the possibility of denial of recovery.

CONCLUSION

This comment has examined the decisions of courts struggling with the implication of a private cause of action under rule 10b-16. This examination has led to the conclusion that notwithstanding a recent trend by the Supreme Court to narrow the implication of private causes of action under federal statutes, an implied private cause of action under 10b-16 should withstand Supreme Court review. Furthermore, scienter should be a requisite element of a rule 10b-16 cause of action.

This comment has also suggested that in conjunction with the goal of federal courts to prevent abuse of the securities laws by investors, the level of sophistication of each particular plaintiff should be

222. See, e.g., *Zurad*, 757 F.2d at 131 (plaintiff who had invested in a number of mutual funds prior to trading in common stock and options was not considered sophisticated in a churning cause of action).

223. See, e.g., *Yopp*, 770 F.2d at 1466 (recovery denied to plaintiff who was a president of a multi-million dollar corporation in a churning cause of action).

224. See, e.g., *Follansbee*, 681 F.2d at 677 (plaintiff who had a college degree in economics and had taken a course in accounting was considered sophisticated and, therefore, was denied recovery under a churning cause of action).

225. See, e.g., *Zerman*, 735 F.2d at 21 (plaintiff's past experience in trading on margin was considered by the court in determining level of sophistication resulting in denial of recovery).

226. See, e.g., *id.* (sophistication may be shown through the use of more than one brokerage firm to trade on margin).

227. See, e.g., *Follansbee*, 681 F.2d at 677 (the amount of control exercised by a broker is a factor in deciding whether plaintiff is sophisticated enough to deny recovery under a churning cause of action).

228. This final criterion is aimed toward differentiating between the investor who possesses many of the other criteria described and the investor with no prior investment experience looking for advice from a broker.

analyzed before recovery is granted under rule 10b-16. In order to promote consistency among the federal courts, this comment has proposed a number of factors that should be considered in determining the requisite level of plaintiff sophistication to support denial of recovery. This comment strongly urges the federal court system to employ these factors to prevent possible fraudulent claims by “unlucky” investors who want to use the margin rules as a “heads-I-win, tails-you-lose” vehicle to ensure personal financial gain.

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